3 March 1977

NOTE FOR: Deputy Director for Intelligence

Sayre -

I don't know whether Hank got to mention this to you, but he'd like an assessment by OER of the alarming Wall Street Journal analysis. Now today, there appears a similar piece in the Post. Perhaps you have already had queries from our consumers. Congress will doubtless be expressing interest as well. In any case, Hank wants to anticipate requests for intelligence support.

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WALL STREET JOURNAL

Debt Threat

Soviet Bloc Borrowings From the West Surge, Amid Mystery, Fears

No Westerners Know Total; Worst Dangers: A Series Of Defaults and Blackmail

Can Big Loans Keep Peace?

By RICHARD F. JANSSEN
Staff Reporter of THE WALL STREET JOURNAL

BRUSSELS—Bankers and military planners aren't likely to have the same nightmares. But the rapid buildup of Soviet Bloc borrowings from Western banks is giving them one in common, and it runs like this:

An American banker is lunching happily with his Russian customers. They thank him for the generous credits, he praises their perfect repayment record, they drink another vodka toast, and then they spring it on him: "Unfortunately, we are unable to continue our repayments."

The banker pales, knowing that he, and maybe his bank, could be ruined. He asks desperately if there isn't any way out, any way at all. Perhaps, the Russians say, there are a few possibilities: A terrorist group in Africa urgently needs dollars, there is some information about U.S. defense contractors. . . .

Only conjecture, to be sure. Neither banking nor defense sources indicate having even the slightest evidence that the Soviets have anything but legitimate economic motives for their borrowing. Yet, nightmarish possibilities are being weighed carefully these days at the Brussels headquarters of the North Atlantic Treaty Organization and in banks from Zurich to New York.

Rapid, Alarming Growth

For the Communist nations' borrowings have become very big very rapidly and have turned into "a strategic consideration—they could bring some banks under," a NATO aide worries. A Zurich banker warns, "The Western community may get in a very exposed position." And an American lender adds that "an air of mystery" is making most Western bankers "more suspicious" lately.

The loans seem mysterious because so little is known about them. Outside the Kremlin, at least, no one knows the total borrowed with any certainty, nor how vulnerable particular banks might be; partly to blame, ironically, are secrecy laws of the borrowing and lending nations alike. Overall estimates do exist, but they vary widely.

According to the Basel-based Bank for International Settlements, the Eastern bloc at last Sept. 30 owed banks in the U.S. and 10 other Western countries the equivalent of $26.8 billion. But although that estimate is considered the most authoritative because it is based on confidential information supplied by central banks, it is admittedly incomplete. It excludes portions of agreed-upon loans that have yet to be actually paid out, loans from governments and credit granted by nonbanking companies, such as manufacturers.

Other Swiss sources put the Dec. 31 total as high as $40 billion, almost double a year before and up from less than $10 billion before 1973. (Generally, lenders lump together the Soviet Union, East Germany, Czechoslovakia, Poland, Hungary, Romania and Bulgaria as Eastern Europe; some include independent Communist Yugoslavia and Red China-oriented Albania as well.)

Further Rise Seen

The total, whatever it may be, appears sure to keep rising, although perhaps less rapidly than before. "I think we will see another year of substantial loans to Eastern Europe," says William Blake, senior vice president of Manufacturers Hanover Trust Co., New York. "If the total is $40 billion today, it will be $50 billion a year from now," a Swiss banker predicts.

The factors favoring more credit are strong, many analysts say. With the U.S. economy growing more slowly than expected, American banks are still eager to offset slack credit demand at home by lending more abroad. And when they consider the shakiness of many developing countries and the heavy debt loads of some industrial nations, too, no place looks safer than the Soviet camp.

"Repayment is their (the East Bloc nations') No. 1 priority, so everybody is falling all over themselves" to lend to them, a Brussels banker observes. Ever since World War II, the Soviet record for repaying Western credits has been "impeccable," a Swiss banker says. Like many others, he figures that the Soviet Union would quietly funnel enough money to any satellite hard-pressed to repay on time, lest any "rescheduling" tarnish Moscow's own top credit rating.

And the Communist powers apparently have ample reason to borrow more. The Soviets need Western technology to develop their industry, oil and other resources, and they finance much of it by borrowing in the West. Other Eastern countries also find it hard to export enough to pay for Western imports, which they may need more urgently to help avert domestic political unrest.

Advocates' Arguments

Generally, such borrowing has the blessing of Western governments, including the U.S. Letting the Soviets, in particular, tap Western credit markets will enable them to improve living standards enough to increase their stake in world peace, the argument goes. The more involved they become with Western trade and credit, advocates say, the more open they will be to Western political ideas and leverage (as with the U.S. trade law aimed at a more-open Soviet emigration policy).

Proponents offer other comforting arguments, too. They note that the most creditworthy borrower, the Soviet Union, also is the heaviest borrower; the Soviets owe $9.54 billion, the BIS estimates. The other debts are: Albania, $16 million; Bulgaria, $1.9 billion; Czechoslovakia, $623 million; East Germany, $3.2 billion; Hungary, $2.9 billion; Poland, $4.9 billion, and Romania, $832 million. The BIS reports $2 billion for Yugoslavia, which it considers outside of the Soviet bloc, and it says it doesn't know how another $2.8 billion is distributed among individual countries.

In addition, advocates argue that Eastern European debt is still a small part of international lending; the BIS estimate of $26.8 billion compares with $248.7 billion for the total foreign loans at the banks surveyed Sept. 30. They say that although the BIS gave up on trying to get loan breakdowns by individual banks, informal soundings indicate that East Bloc debt is fairly evenly spread among the 50 or so largest Western banks. (The BIS doesn't publish a breakdown by lending country, because so many loans are routed through bank branches in London, the center of the Eurocurrency market.) And they note that part of the debt is offset by Eastern European deposits in Western banks; the BIS says it knows of $6.1 billion of such holdings.

But as the debts grow, so do the doubts.

Henry Kissinger started the worries rippling widely. In a speech in Paris last June, the then-Secretary of State described the surge as "sudden" and "striking," and he raised—without answering—the question of its worrisome implications.

The most fundamental worry is that it is the Soviets who are gaining leverage over Western lenders, and not the other way around. "We have a saying," a Swiss banker notes. "Make a small loan, and you have created a debtor. Make a large loan, and you have created a partner." There isn't any doubt, an American adds, that a very big debtor has great influence over a bank, because he can embarrass it, or even ruin it, by refusing to repay.

String of Defaults

"I don't like to use the word blackmail," starts off a Continental banker deeply involved in loans to the East. But that's what it could amount to, he adds, if the Soviets ever were to seek "favors" as a condition of keeping up their repayments. It needn't be anything as sinister as the espionage or illegal loans envisioned in the nightmare situations, another adds, without ruling them out. Most likely, this banker frets, the Soviets would seek such commercial favors as the bank pressing its corporate customers of its country's government to import Soviet goods in order to make repayment possible.

In the most extreme nightmares the debt is seen as giving the Soviets a lever they could use to deliberately shake the West's financial structure, and thus its economy and military power, too. "A possible scenario in a time of increased tension" includes a coordinated cutoff of repayments with a "multiplier effect of defaults," a Brussels-based analyst says.

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Nothing so grave is likely, even the most somber strategists emphasize, unless relations between the U.S. and the Soviet Union were collapsing anyway. But that's something that NATO must plan for, and that bankers, too, take into consideration. "If someday, virtually overnight, we're virtually at war, then we could kiss the credits goodbye," Mr. Blake of Manufacturers Hanover concedes. But he's counting on any political deterioration taking place slowly enough that the debt could be run down "over a period of years."

A subtler strategic worry is that the Soviets may be borrowing partly to sop up credit that otherwise might be used to strengthen the poor countries against Communism or to meet energy and other capital-investment needs in the NATO democracies. One question the borrowings raise is whether Moscow wants Western funds "to stop them being used in other theaters of economic operations," suggests Jacques Billy, NATO's chief economist.

That's one of the questions prompting the European Community to take a closer look, too. A Common Market official in Brussels says, "$40 billion isn't peanuts." With the U.S. and Western Europe worried about a long-run capital shortage that could retard growth and raise costs, he explains, "we have to consider whether it is wise to provide so much capital" to Communist countries.

Source fo Funds in Doubt

A more immediate question in EC circles is *how* the East Bloc will pay its debts. "The question isn't will they pay or won't they pay," the official says. Instead, he says, it is how they will manage to scrape together all the dollars needed to pay back the debt with interest.

One way they often take is to insist that a Western company accept payment in Communist products instead of Western cash. "If you export cars and are obliged to take tomatoes, you will sell tomatoes at a very low price," says the EC man, noting "more and more complaints" about market disruption wares in payment turn them over at a deeply discounted price to specialized brokers, who unload them cheaply into Western retail outlets.

A somewhat longer-run Common Market concern is that the Eastern countries will conserve their Western funds for debt repayment by slashing imports. Because many Western European industries sell large amounts of machinery and other goods to Eastern European countries, EC officials worry that repaying loans to American banks will cause layoffs at factories in West Germany, for instance.

Exactly how the Red debtors will earn the repayment money is discussed among bankers, too, partly because Russian consumer goods generally are deemed unappealing by Western standards. "There are some doubts as to their ability to pay the debt off in manufactured goods, so their exports will have to primarily come in raw materials and energy," comments Hans Mast, chief economist of Swiss Credit Bank in Zurich.

Vast Natural Resources

It is those vast natural riches that bankers consider the most solid backing for their Soviet loans, along with their confidence that Communist regimes can simply order any living-standard curbs necessary to meet repayment schedules. If it comes to that, "those countries truly will pull in their belts until they don't have any waists left," an American banker says.

In recent months, though, doubts are creeping in about whether the Soviets do stand behind all the debts of all their allies. Because of the unquestioned loyalty to the Kremlin of East Germany and Bulgaria, their debts are deemed the most likely to stay under the Russian "umbrella." To one Swiss banker, the Romanians and Hungarians are "the biggest risks because they don't always see eye-to-eye with the Russians."

Since a surge in Polish food prices sparked labor unrest there last summer, Poland is the East Bloc debtor getting the wariest looks from lenders. Their scrutiny doesn't indicate that the Communist regime will crumble, certainly, but it does show, one European analyst advises, that the country's finances are "approaching a critical position."

A rule-of-thumb in international lending is that no more than 25% of a country's export earnings ought to be needed to service its foreign debt, he explains. And according to the Economic Commission for Europe, a Geneva-based United Nations unit, principal and interest payments to the West appear to "have reached some 25% of Polish exports" to the West.

UN Estimates

Other Eastern countries haven't made such ratios public lately, but UN sources put the Soviet ratio at something over 20%; and the rest at lower, considerably more comfortable levels; estimates include about 18% for Bulgaria and Romania and around 11% for Hungary and Czechoslovakia. That leaves most of them with ample elbow room to take on more debt without jeopardizing their ability to continue vital imports, most bankers say.

Nevertheless, some of the bankers most active in lending to Eastern Europe contend that the rapid expansion is over. A technical factor is a U.S. law limiting loans to any one customer to 10% of a bank's capital and surplus. Unless various agencies in the Soviet Union come to be legally treated as separate customers, some U.S. banks could bump up against that limit before long, sources suggest.

In addition, many big Western banks may be coming close to the "country limits" that they themselves set to avoid having too many eggs in one basket. Satisfied to have become established as lenders to the Bloc, others say they can afford to be more selective now as to country, and to demand more in return, such as higher fees and more financial data.

Also likely to make future growth slower, diplomatic analysts say, is the reluctance of some Bloc countries to becomd too deependent on Western technology; thus they may restrain the importing that gives rise to the debts. Some senior bankers, however, scoff at talk of a credit slowdown. "I've been hearing it for 18 months, and I don't see any sign of it yet," one declares, and another laments that he can't reject a Soviet loan if that would cause a big customer to lose a major export order.

Rates Paid by Soviet Bloc On Loans Also a Mystery

By a WALL STREET JOURNAL *Staff Reporter*

BASEL—Just as no one in the West knows the amount of Soviet Bloc debt, no one knows exactly what rates the bloc is paying. Even in large "syndicated" loans, banks seldom disclose the fees that they are getting on top of the announced interest rates.

But a rough guide to the relative credit ratings—a measure of the risk the lenders see—exists in the standard discounts charged by Finanz AG Zurich, a unit of Swiss Credit Bank, in purchasing medium-term credit "paper" from Western exporters.

Those rates can vary in each transaction, but the Soviet Union clearly enjoys the highest standing and thus the lowest basic rate, equal to 8⅛% annual interest. That's less favorable than the 6¾% U.S. rate, but well below the 10½% applying to Argentina, for instance. East Germany and Czechoslovakia qualify for 8⅜% and Poland and Romania for 9%. Yugoslavian debt incurs a stiffer 10¼%; bankers generally attribute that to inflation, lack of Soviet backing, and the possibility of trouble if Russia tries to drag Yugoslavia back into its sphere.

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Threat to West Seen in Rising Soviet-Bloc Debt

By Bernard D. Nossiter
Washington Post Foreign Service

LONDON, March 2—The explosive growth in Soviet-bloc debt confronts the West with a "serious" and continuing problem, a study here has concluded.

An unpublished report by Prof. Richard Portes of London University warns that the expanding mountain of Eastern European debt could reach $100 billion by 1980. By then, Poland for one will probably need to have its debt "rescheduled," a banking term for making new loans to save old ones from default.

This state of affairs, Portes says, is made even more precarious because the biggest share of the credits is now coming from virtually unregulated private Western banks. Their entry "implies a straightforward loss of governmental control over Western lending policy."

According to Portes, these bankers are employing foreign deposits in the uncontrolled Euromarket, displaying dubious judgment about credit risks and lending to the bloc on a fraction of the information and none of the collateral required from conventional borrowers. The bankers appear to be counting on Western governments to bail them out, for both political and economic reasons, if their loans go sour.

Portes concludes that the mounting bloc credit not only endangers Western banks but also tends to drive weaker satellite debtors closer to the Soviet Union. This is the very reverse of a justification often advanced for making loans to Poland, Bulgaria and others.

Portes is a Yale and Oxford-trained economist, a former Rhodes scholar who has taught at Princeton. His paper, which is circulating among European and U.S officials concerned with Soviet trade, is believed to be the first serious attempt to assess the implications of the credits.

The organization for Economic Cooperation and Development, spurred by warnings from former Secretary of State Henry A. Kissinger, has compiled its own extensive statistical analysis of East-West credits.

But this still-secret report scrupulously avoids any conclusions. Some OECD members, notably the French, regard the concern in Washington as a trick to deprive Western Europe of markets and influence in the East.

Western credits to the bloc, almost equally divided between government-backed and purely private loans, have mushroomed in the last five years.

By the end of last year, bloc debt to the West was estimated at $40 billion, including $15 billion for the Soviet Union and an outsized $10 billion in Poland. But big as this is, Portes says, it understates the volume of IOUs the bloc has signed. All together, Portes calculates, the West has extended credits of nearly $60 billion. The extra $20 billion is for loans against which no deliveries of Western goods have yet been made.

If the rate continues through 1980, Portes estimates, the debt then will stand at $100 billion. That would be well above the total extended to developing countries in the Third World, a credit risk that has just begun to worry Western banking officials.

The credits, Portes observes, would pose no problem if they financed industries that could produce a matching stream of goods sold to the West. But, he says, most of the capital and technology produces goods for sale inside the bloc—autos, petrochemicals and the like.

Portes questions the bloc's ability to generate enough exports to pay for the loans in any event. He takes no position on the argument frequently advanced that the economies of the East are too rigid to produce what the West would buy.

The London economist describes a dilemma that makes debt repayment even more difficult. If the West expands, it widens the gap in technology over the East and makes Eastern goods even less salable outside the bloc or the Third World. If the West slumps, demands for protection against "unfair" bloc competition choke off markets. Finally, the complex Common Market system to protect European farmers cuts off potential agricultural sales from Hungary, Bulgaria and Romania.

What saves this house of cards from collapse, Portes believes, is the Western fear of default by any borrowing nation. Banks and governments alike worry that one country's going bankrupt would set off a "domino effect."

So India, Zaire and like nations have discovered that the West will "roll over" or "reschedule" debt payments they cannot meet. In effect, the debtors swap old paper for new, with Western governments standing behind their reckless banks.

In the Third World, however, these concessions are rarely made without some plan, supervised by the International Monetary Fund, to shrink the buying appetites of the borrowers. Portes observes that it is inconceivable that Poland or some other likely defaulter would allow the IMF in.

Portes foresees 1980 as a critical year. Then, a big chunk of loans will come due. "There is a significant probability," he writes, "that at least Poland and perhaps other East European countries will have to reschedule their hard-currency debts."

Portes argues that the debt is now so big that it gives the borrower—not the lender—the leverage. The Soviet Union and the satellites can borrow without fear, confident that neither Western banks nor Western exporters can easily afford to cut them off. A collapse of loans would damage some banks and a sudden loss of Eastern orders could hit some manufacturers.

Private lenders have said they do not worry because the Soviet Union stands behind every bloc debtor. But if Eastern European nations must turn to Moscow to be bailed out, Portes says, their dependence on and ties to the Soviet Union will be much tighter.

Neither the U.S Federal Reserve nor any other central bank has much control over the Euromarket operations of banks whose loans at home are supposed to be carefully scrutinized. In other words, bloc debt is fueled by unregulated and uninspected lenders.

At a minimum, Portes says, banks and governments must compel bloc borrowers to reveal the size of their burden, the maturities and interest on their outstanding debt. This data, required from every other borrower, private or public, is withheld by bloc nations.

Portes suggests that the West might "accept a fairly rapid growth in the debt" if terms and amounts were "coordinated" through an international body like the OECD. But, as the study observes, competitive rivalries—both political and economic—among Western nations have so far prevented any such moves.

There are only two ways to reduce the debt, Portes concludes. Countries with trade surpluses such as West Germany, Japan and the United States now and Britain over the next 10 or so years could agree to take more of the goods that the East has so far been unable to sell. Or they [illegible]nance the sale of such goods to Third World Nations.